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Random musings for traders at TD Ameritrade—SUMMER 2021

SPECIAL FOCUS:
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FOUR STEPS TO
FINDING YOUR (TRADING) ZEN

LEARN TO DEVELOP A CENTERED MINDSET
PAGE 16

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There's a whole universe of exchange-traded funds (ETFs) and notes just waiting to be discovered. Learn about the different types: index, sector, bond, commodity, leveraged, inverse, volatility, and more.

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The Reopening Thwump

• AS WE CLIMB the pandemic wall of worry toward herd immunity, can we finally achieve the economic reopening we've been waiting for? Traders want to know.

We're not out of the woods yet. Some countries continue to struggle with new COVID case numbers going in the wrong direction. But in countries where cases are declining, more people are flying, eating out, and—dare we say—going to the movies. Still, others are content to stay comfy at home streaming and zooming. After all, who wants to return to the dreaded commute? So, we could see a hybrid reopening/stay-at-home lifestyle become the new normal as we come out of the pandemic.

In the end, we don't know how this will play out in the markets. But one thing we do know: The markets will remain unpredictable. Some might think an economic recovery would provide a tailwind for the stock markets, but that may already be priced in. Perhaps interest rates will jump higher or investors may get jittery about higher capital gains taxes. Everyone knows markets can be irrational and often leave us feeling dejected and emotionally drained. Emotions and trading don't get along well, which is why it's important for traders to have a calm mind before placing a trade.

The article "Four Steps to Finding Your (Trading) Zen" on page 16 could help you find a centered approach to tackling the markets. And no, it's not about taking supplements, eating a healthy diet, or exercising. It's mindfulness for traders. When you recognize what type of trader you are, you can utilize the strategies that fit with your trader personality. There's no need to chase every meme stock or cherry-pick every new strategy. Focusing on achieving your goals with a clear, focused head will leave you less overwhelmed by all the information that's out there. Feeding our brains with the right information tends to help us make more rational trading decisions.

Speaking of rational, many tools could better prepare you for different scenarios the market may throw at you. In "Risk Profile: The Option Trader's Travel Companion" on page 20, you'll learn how to analyze different "what-if" scenarios so you're better able to manage risks. Things can change more quickly for option traders, so you're going to have to keep an eye on more variables than price—like time and volatility, for starters.

We'll see a lot of changes and new paradigms coming out of the pandemic. Be prepared for anything, and more important, be centered and enjoy your summer.

Happy trading,
Kevin Lund
Editor-in-Chief, *thinkMoney*

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IN THE MONEY

INDUSTRY SPOTLIGHT

Exploring Emerging Markets

When looking for volatility, you may want to check abroad. Potential trading opportunities may be lurking.

• NOT EVERY TRADE IS DRIVEN BY AN all-consuming sense of purpose. You may often trade simply because you want to, especially when there's lots of price movement. It may not always be a winning proposition, but there are times when you just want to be involved.

If you're looking for lots of movement, you might consider emerging markets. They tend to be volatile even at the best of times, and they can move up or down even faster when financial winds change course. In 2020, the MSCI Emerging Markets Index (MXEF) rose more than 20%. Could this indicate emerging markets are "emerging" from COVID-19? As vaccine distribution improves globally and hopes of economic recovery increase, it's probably a good idea to keep a close watch on those territories.

INTEREST RATES AND THE GREENBACK

Consider this: For several years—even before the pandemic—low U.S. interest rates and a soft dollar injected fuel into emerging markets, especially the largest. A weaker dollar can strengthen currencies in emerging markets, which can make it easier for overseas companies to manage debt. That's one reason a weak dollar often correlates with emerging-market equity strength.

By spring 2021, the MSCI BRIC Index (which measures equity market performance across the four "BRIC" countries: Brazil, Russia, India, and China) was up more than 32% from a year before. That beat the S&P 500 Index (SPX) for the same time period and wasn't far from all-time highs.

Even so, as of spring 2021, the average BRIC Index return over the last three years was only about 7%, meaning BRIC might

PHOTOGRAPH: DAN SAELINGER

have gotten out over its skis thanks partly to the pandemic. That became clear in 2021 as U.S. interest rates rose sharply from all-time lows and the dollar showed signs of waking up from its year-long nap. The old saying is that when the biggest markets sneeze, emerging markets catch a cold. Massaging that phrase a bit, could a Western market recovery from COVID-19—perhaps with rising U.S. interest rates and a healthier greenback—trigger an emerging-markets flu?

The answer is far from clear. But if you're looking for volatility to flex your trading muscles, consider a 10-year standard deviation (a measure in which a lower percentage means less volatility) of 13.74% in U.S. equities versus nearly 20% in BRIC. It's clear that emerging markets show signs of squall more than U.S. stocks. And the higher volatility shouldn't come as a surprise. Because when emerging markets tend to be in growth mode, there could be more political, regulatory, or currency risk.

CONSIDER THE TRENDS

If you want to trade or invest in emerging markets, keep an eye on the MXEF. If you think an uptrend may be in its early stages, this could be your place and time. You might not always come out ahead, but you can count on the trade winds to keep blowing. —Words by DAN ROSENBERG

Dan Rosenberg is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

Emerging markets investments tend to be less liquid and more volatile and are subject to a number of additional risks, including but not limited to currency fluctuations and political instability.

THINKTANK

Keep Those Trading Ideas Coming

What are you going to trade next? With a gazillion choices, that could be a tough question to answer. Try using the MarketWatch tab on thinkorswim® to narrow things down.

Trading based on what you hear on social media sites may technically work, but it may not be the smartest approach. You want to trade something that has high odds of making money, so it's worth taking the time to do some homework.

The MarketWatch tab on the thinkorswim platform has tools that can help you (logically) filter the universe of tradable products.

VISUALIZING IT

A visual snapshot of the entire market could go a long way in helping you get a lay of the land. The Heat Map on thinkorswim gives you a big-picture view of sectors or stocks (see Figure 1).

1 – Select the **Visualize** subtab.
2 – Select **Heat Map** from the **Visualization** menu.
3 – Under **All Watchlists**, expand **Indices**, **Public**, or **Personal** to start your filtering process.

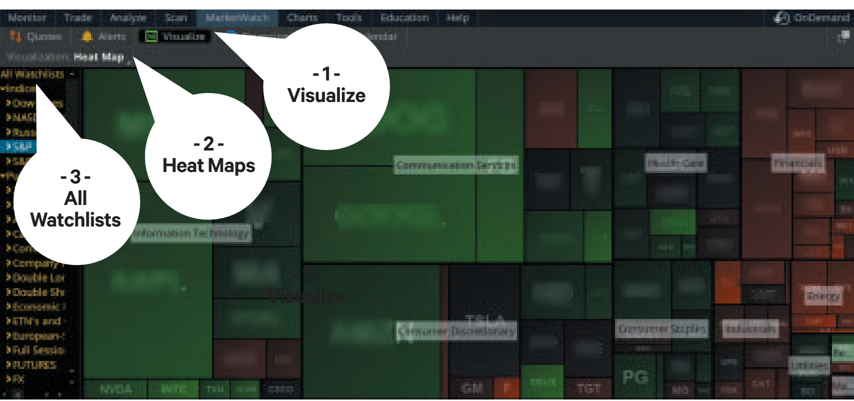

FIGURE 1: NIGHT VISION FOR TRADERS. The Heat Map gives you an overall view of the markets at a glance. *Source: thinkorswim. For illustrative purposes only.*

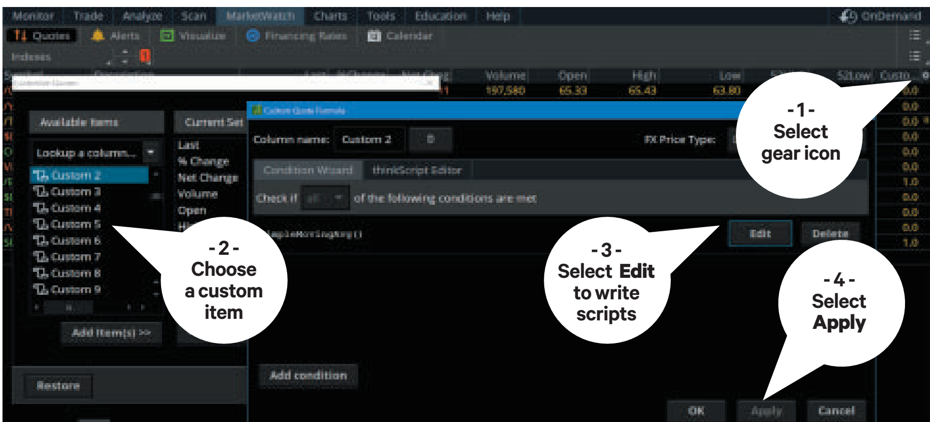

FIGURE 2: CUSTOMIZE QUOTES COLUMN. **You can create and add custom scripts from the Quotes tab on thinkorswim.** *Source: thinkorswim. For illustrative purposes only.*

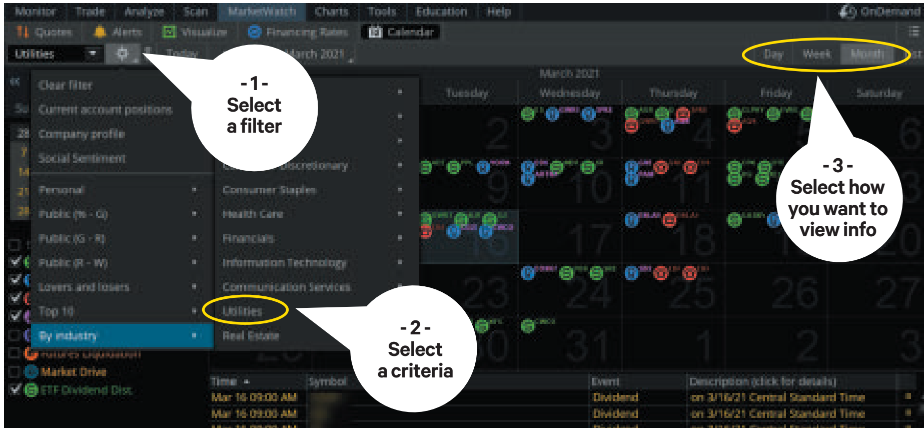

FIGURE 3: LOOKING AHEAD. **The Calendar on thinkorswim helps you see when events such as earnings and dividend distributions are coming up.** *Source: thinkorswim. For illustrative purposes only.*

For example, if you select Indices, you can go through the list and see the Heat Map of the S&P 500, S&P 100, Russell 2000, Nasdaq-100, and Dow Jones. At a glance, you can see how the stocks that make up each index are performing on the day. Green is up, red is down, and gray means unchanged. Bigger boxes represent larger stocks in terms of market cap. The brighter the color, the bigger the move.

Hover over any of the stocks to access more details. Are there too many sectors or stocks to choose from? You can use the Indices menu to select a specific index. Expand the index and then select a sector, subsector, and finally individual stocks. Select any stock you might be interested in and drill down some more by looking at the stock chart, company fundamentals, news, and so on. You can do a really deep dive on the **Visualize** subtab.

CUSTOMIZE QUOTES

Now that you've filtered down a bunch of stocks, it's a good idea to add them to a watchlist. Using the menu at the top, select the **Quotes** subtab and the watchlist you created. If you have a lot of watchlists, you can scroll through them using the up and down arrows to the right of the menu. You can also link the Quotes list to **Charts** and scroll through price charts of the entire list. But there's more to the Quotes subtab than viewing quotes. Sure, you can choose to display data such as volume, percent change, net change, 52-week high/low, and so on, but you can also customize a column (see Figure 2).

1 – Select the small gear icon at the top right.

2 – Select **Customize** and choose from the numbered custom items on the list.

3 – Try creating a custom item by writing your own script. In the **Custom Quote Formula** window, select **Edit** and try writing your own script with thinkScript®. It could be something simple such as a moving average crossover.

4 – Select **Apply** and your script will be displayed in one of the columns.

CALENDAR PLANNING

Now that you've got your list of what you might want to trade, the next big question is: When should you place the trade? It might be helpful to know if there are any related events coming up such as earnings, dividends, or stock splits. Select the **Calendar** subtab, and below it, check off the event types you're interested in (see Figure 3).

1 – Select the gear icon to choose one of the available filters.

2 – Suppose you think Utilities are due for a rally. Select the gear icon and choose **By industry** > **Utilities** > **Select All Utilities**.

3 – Choose from Day, Week, Month, or List for your preferred display.

The calendar will populate with the companies that have events coming up in the selected month. Choose any day on the calendar, and the events will appear in a list underneath. Now you can go through the list to do a more thorough analysis. If something stands out, set an alert so you're notified of the event.

With these three tools, you have a more logical process for deciding what you want to trade next. Plus, you become a more informed trader.

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An Options Strategy Styled for You

With many options strategies to choose from, how do you find the right fit? Consider a three-step process.

CAMERON MAY
EDUCATION COACH
TD Ameritrade

• When you're shopping for spaghetti sauce, having several choices is great. Same thing with options strategies. But with all those various strategies, strikes, and expiration dates, how do you choose?

When you're starting with, say, 60 options strategies, you need a process to get that number down to a manageable level. Start with three basic questions:

1. Are you bullish, bearish, or neutral? This answer can narrow a list fast—by half or more. If you're looking for a market advance, you're likely not shopping in the long put verticals aisle.

2. Is it a buyer's or seller's market for options? In other words, where's volatility being priced in the short term and longer term, and how does that rank against historical levels? This narrows a list even further.

3. Are you looking for high probability or high potential reward? Trading would be a lot easier if you could have both, but that's not the way it works. It can feel like the ultimate trade-off. When you swing for the fences, it's great when you connect, but you often skulk back to the bench after striking out. Or you can grind it out with base hits—unglamorous and labor-intensive, but it gets the odds working for you.

TRADER GLOSSARY
TURN TO PAGE 33

AN SPX EXAMPLE

Suppose you expect the S&P 500 Index (SPX) to trend higher in the weeks to come. Now look at the Cboe Volatility Index (VIX). Let's say it's in the upper 20s. You check the chart and see that's the high end of where it's been in recent days. (Note: You can also get a volatility [vol] snapshot by looking at the implied and historical vol percentiles for any stock, index, or exchange-traded fund on the thinkorswim® platform on the **Trade tab** > **Today's Options Statistics**.) Maybe your convictions aren't terribly high; you think this rally could be a slow burn, and you typically like to play high-probability grinder ball.

So, you're looking to the upside. Short and neutral strategies are out. No long puts or put verticals, and no strangles or iron condors.

Vol is elevated, and your conviction isn't super high. Rule out long calls with high vega. You might also rule out buying low-delta, low-vega calls because they'd be low probability. A long call butterfly—with the middle strike centered around your upside target—could fit the bill. But it's not a high-percentage play.

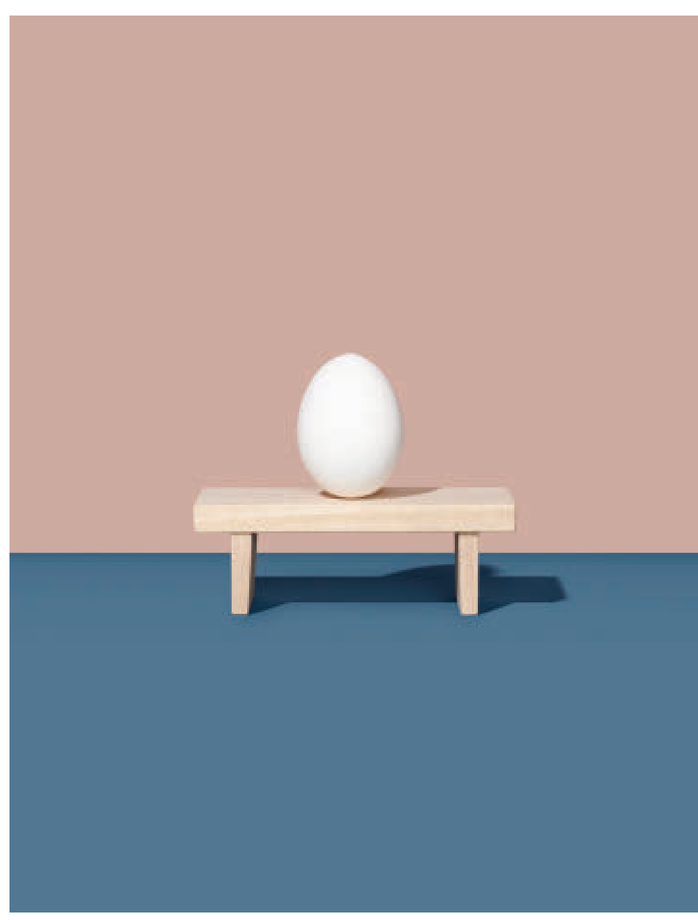
From here, it all depends on your risk tolerance and personal preference, but the leading candidate looks to be a short put vertical with a few weeks until expiration. Next, you can look at strike selection, keeping that ever-critical trade-off between high reward and high probability in mind.

Above all, you've created a process by which you can narrow down the options strategy choice set. Now, about that spaghetti sauce? You're on your own.

JOIN THE WEEKLY WEBCAST

"Selecting an Options Strategy"
Take an interactive walk through market considerations. Register at events.thinkorswim.com.

PHOTOGRAPH: DAN SAELINGER



Reached Max Risk and Still Have Cash?

We asked James Boyd, Education Coach at TD Ameritrade, to share his thoughts.

Hey Coach! I have a portfolio with several options positions, but I've reached my max risk level and still have cash in my account. Should I be managing my risk differently?

That's an interesting question, because traders often focus on individual risk instead of portfolio risk. For example, traders may be willing to risk $1,000 on each trade, but they may not think about how much they're willing to risk on their entire portfolio.

First of all, if you're at max risk, it's probably best to stand down. The more trades you put on, the more risk you're likely to have. It could be time to exercise some discipline. When you put on a position, have a clear understanding of your reasons for getting into that trade. If you're at max risk, it may indicate that you should slow down.

That said, suppose you have 10 positions open and reach your max risk. Most likely, you didn't open all 10 in one day. You probably started out with a few, then added more a few days later, and so on.

If it were me, I'd review those positions. Perhaps you could raise your stops on positions that are profitable so you may be able to exit those positions earlier than planned. For example, you could move up a stop based on a 10-period moving average instead of a 30-period one. To raise the stops, you may have to let things trend awhile to see if the support levels move higher.

You could also check if any of the trades are close to your price targets. Are any stocks near a resistance level or close to (or even above) your profit target? For example, when you enter a trade, say you want the reward to be higher than the risk. But when price is close to your target, risk/reward dynamics may change. You might be better off selling into the strength.

Likewise, look at the overall market and identify strong areas or sectors. Then consider whether you have exposure in these areas of relative strength. You want your positions to be in the stronger sectors and avoid the weaker markets.

LEARN MORE

START YOUR OPTIONS TRADING JOURNEY

On the thinkorswim® platform, select the **Education** tab, then **I want to trade stocks or options** > **I want to start trading options**. There are tons of articles, webcasts, videos, and workshops to choose from.

Instead of using stops, are there other ways I can manage risk?

Here's another approach: Consider all your positions. Can you place protective puts on any of them? You may be taking less risk than if you were setting stops. That's because if price goes down to the stop, even for a split second, the stop may trigger.

With a protective put, if the stock price goes down to the long put strike, it doesn't necessarily mean you're out of the trade. So, placing a protective put could help better manage risk, but keep in mind that the puts will cost you and they could end up expiring worthless.

Bottom line: As you trade, instead of looking at risk on a trade-by-trade basis, analyze it from the perspective of your entire portfolio.

For more on the risks of trading and trading options, see page 35, #1 & 2.

A trailing stop or stop loss order will not guarantee an execution at or near the activation price. Once activated, they compete with other incoming market orders.

PHOTOGRAPH: DAN SAELINGER

How is futures margin different from equities margin?

When you trade futures, you often wind up with a lot of questions. That's why, at TD Ameritrade, we have on-demand education, futures specialists ready to talk day and night, and an intuitive trading platform. So whatever the question, you'll have all the answers you need.

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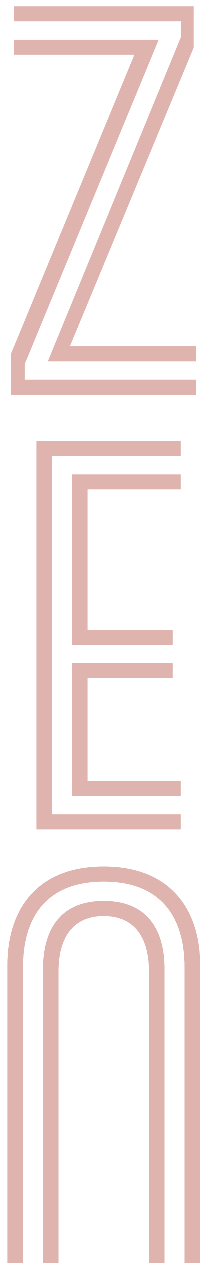
SKILL LEVEL **EASY**

TAKE AWAY:
Know the tools that can help you achieve a trader's mindset.

FOUR STEPS TO FINDING YOUR (TRADING)



BIG IDEA:

WHEN YOUR TRADING LIFE PULLS YOU FROM ALL SIDES, HOW DO YOU FIND YOUR CENTER? CONSIDER THESE STEPS TO HELP YOU DEVELOP YOUR TRADING MINDSET. WORDS BY **DOUG ASHBURN**

PHOTOGRAPHS BY
DAN SAELINGER

EVER GET

to the end of a trading cycle and feel like you were your own worst enemy? You overruled your game plan and started second-guessing your second-guesses. Then, by the time you hit the red button, you just felt relieved to be out of the trade. You might've even made money—but it left you so mentally drained that it felt like a loser.

It happens to the best of us. Here's the thing: From a point-and-click perspective, trading's never been easier. But mentally and emotionally, it's perhaps never been this hard. It's easy to get distracted and stressed—and the amount of data available these days can be overwhelming. If your trading life starts to pull you in all directions, it's important to recognize that you need to get back to your center. In other words, find your trading Zen.

Nope, this isn't another recommendation to eat right, exercise more, take up yoga, or buy a bunch of self-help books. There's nothing inherently wrong with any of those things. But you might consider looking closer to home for the key.

Spoiler alert: Helpful tools are on the thinkorswim® platform. Fire it up and consider these four steps as you work to reclaim your center.

STEP ONE

BECOME MORE SELF-AWARE

In the words of the late economic analyst George Goodman: "If you don't know who you are, the stock market is an expensive place to find out."

So, who are you? What's your "trader personality"? A good starting point might be to answer these questions:

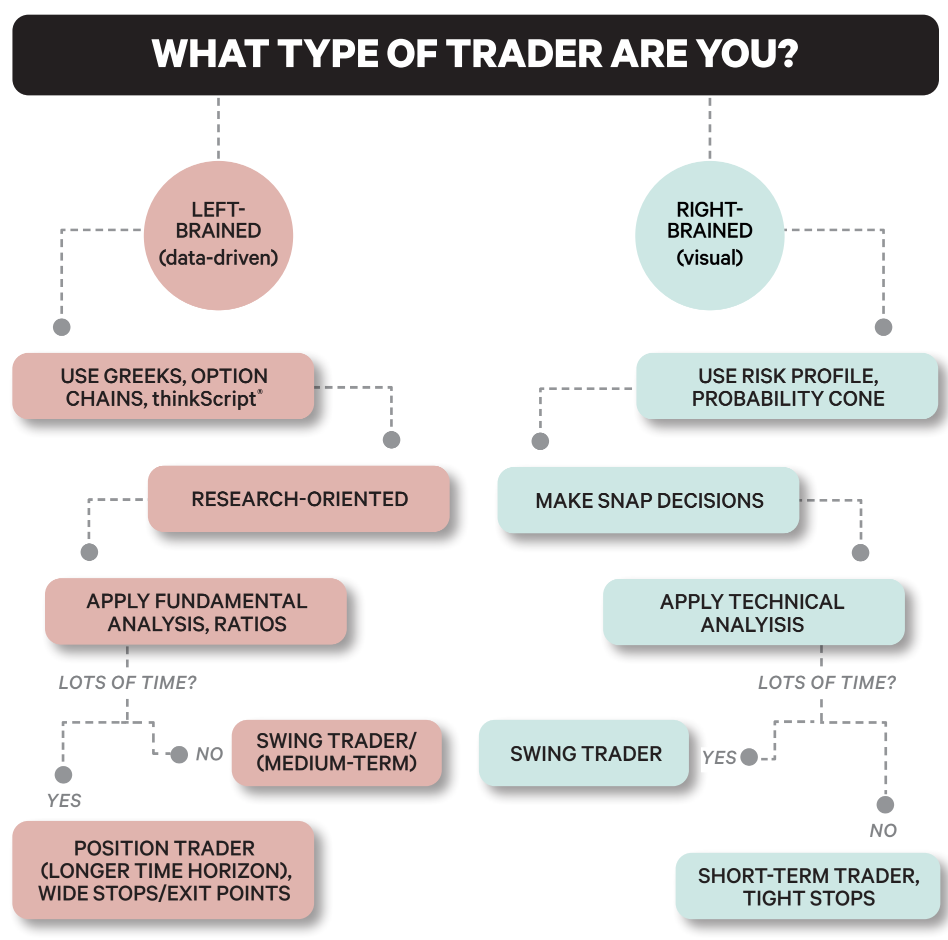
- Are you left-brained or right-brained? In other words, are you all about the math, numbers, and logic, or are you a creative, intuitive, visual learner?
- Do you like to analyze all the angles and plan scenarios and contingencies, or are you comfy with snap decisions?
- How much time do you set aside each day for trading and trading research? An hour or less? Or are you on the platform day and night?

Answering these and similar questions can help you outline your optimal game plan. If you're an engineer type, you might like some of the hands-on, automated tools and gizmos on thinkorswim, such as automating trades with **Strategy Roller** or writing your own code hacks in **thinkScript**. Visually oriented traders might prefer to use technicals and manage order entries and exits directly from the charts. Like to analyze? There's an entire tab devoted to analysis tools, as well as a button (**OnDemand**) that lets you turn back the clock for backtesting and scenario analysis.

STEP TWO

CLEAR YOUR HEAD

Remember that double-edged sword of available data? It really can be TMI. But relative to your trading strategy, a lot of it is extraneous noise. Too much clutter upstairs? It might be time to clean house.



Rather than letting your attention focus too much on the bright, shiny object or on stuff that doesn't matter, focus on what's relevant to your game plan. Once again, thinkorswim can help give your brain a break.

For example, option traders can use the **Risk Profile** (see "Risk Profile: The Option Trader's Travel Companion" on page 20) to crunch the numbers and track the options greeks. And you can clear your head of dates to remember, like expirations, economic reports, and ex-dividend dates. Just go to the **Calendar** under the **MarketWatch** tab.

Do you spend too much time looking for trade candidates and strike prices? Head over to the **Scan** tab, set your parameters, and narrow the list. And don't obsess over your entry/exit parameters; instead, try setting up **Alerts** (see Figure 1).

Think of these tools as outsourcing brain-sucking tasks to a tech platform that's designed for it.

DID YOU KNOW?

Some personality tests detect your tendencies during normal times as well as times of stress. Many of us are entirely different people when our blood pressure builds and the hair on the back of our necks stands up. When you log in to the trading platform, make sure you know which personality is with you.

STEP THREE

NURTURE YOUR BRAIN

It goes without saying that you need to feed your body with the stuff vegetables are made of. But what are you feeding your brain? Reliable daily market information, news, and education is the brain food for good ideas.

Once again, it's all there on thinkorswim. Swing by a chat room and bounce ideas off fellow traders. Or take it one step further and tune in to the programming available from our media affiliate, the TD Ameritrade Network*, for a full trading day's worth of live programming from early morning until an hour past Wall Street's closing bell. Plus, you can always access free courses, articles, videos, and live webcasts under the **Education** tab.

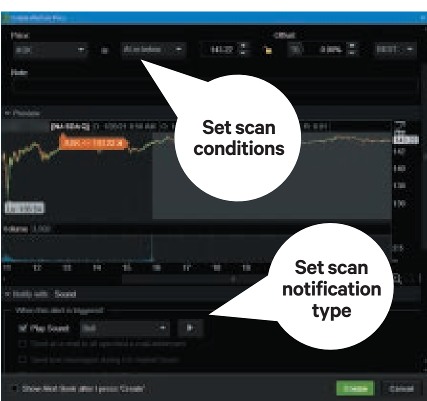


FIGURE 1: PULL UP AN ALERT. **From the MarketWatch tab on thinkorswim, select Alerts, edit the values you'd like to be alerted about (such as the bid or ask), choose how you'd like to be notified, and create the alert.** *Source: thinkorswim. For illustrative purposes only.*

STEP FOUR

TRADE LIKE A MACHINE

If you've followed the first three steps, you should be closer to finding your trading Zen. You've assessed your personality and synced it with your trading style. You've cleared some of the junk out of your body's attic to make room for the stuff that matters. And you've started feeding your trading brain a healthy diet of nutritious content.

If these initial steps are about getting you back to or finding your center, this next step is about keeping you there. One approach: Put your trading decisions on autopilot. "Black Box Trading for the Rest of Us, Sort Of" in *thinkMoney* 49 spelled out one example of a quick, simple, rules-based trading system:

- Define the objectives (the fewer, the better)
- Outline the scenarios and probabilities of each scenario
- Play the game to its end (for better or worse)

Setting up a trading "machine" can help filter out those extraneous variables from the equation. It's a bit like what the ultrafast trading systems do—simplify the inputs to streamline the outputs.

TRADING IS HARD ENOUGH IN THE BEST of times. So, don't make it harder than it needs to be. Find your Zen to become a more objective and centered trader. It will take some practice, diligence, and maybe a cup or two of herbal tea.

TOOL TIPS

AUTOMATE YOUR TRADES

For more on how to use Strategy Roller, read **http://bit.ly/TT-Rolls**

WRITE YOUR OWN SCRIPTS

It's not as hard as you may think it is. Read **http://bit.ly/TT-Script**

Doug Ashburn is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

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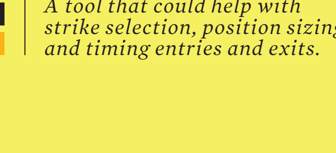


TAKE AWAY:
A tool that could help with strike selection, position sizing, and timing entries and exits.

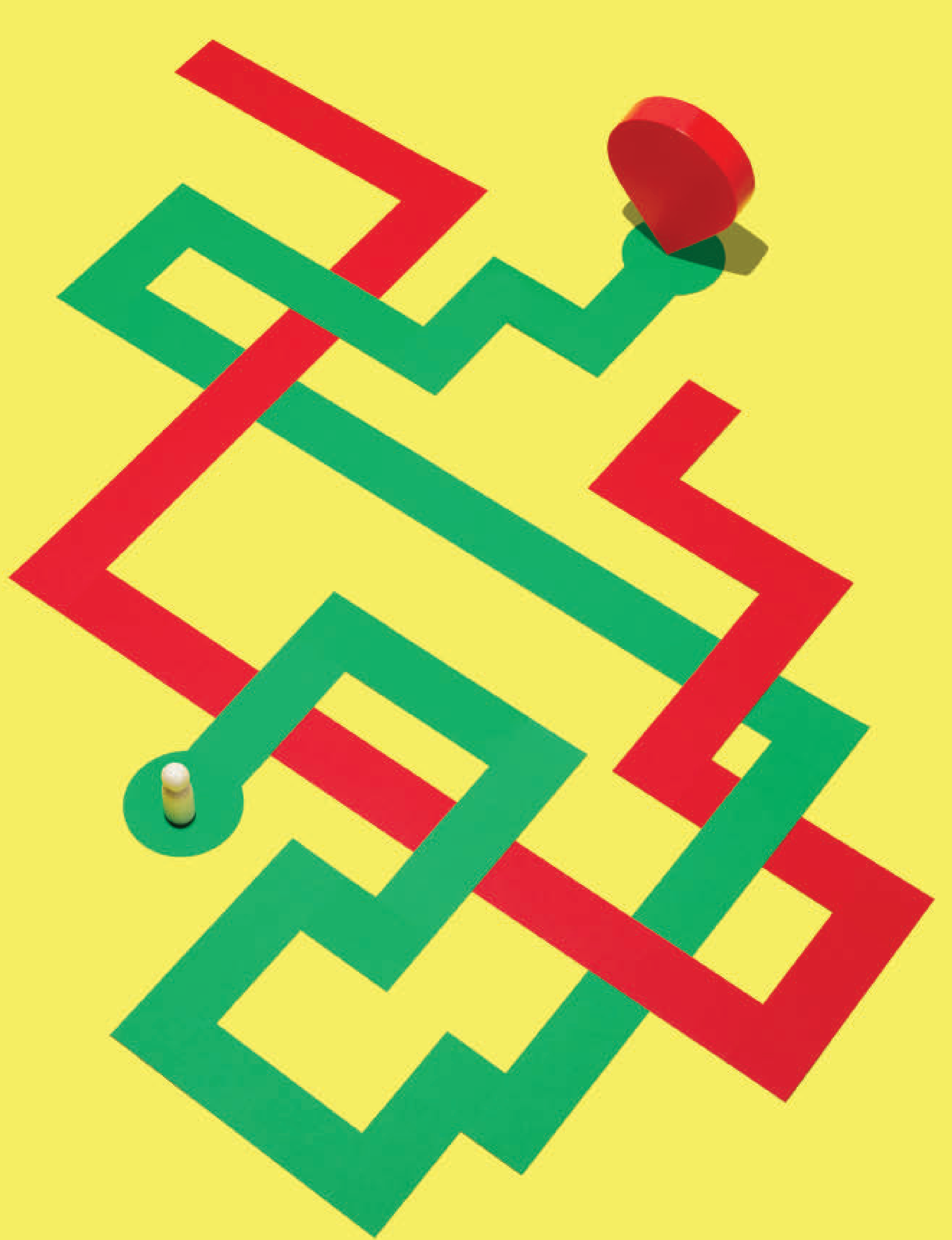
RISK PROFILE:

THE OPTION TRADER'S TRAVEL COMPANION

BIG IDEA:
WHEN TRADING OPTIONS, KEEP IN MIND THE RISK CURVE CAN LOOK VERY DIFFERENT AT TRADE ONSET VERSUS EXPIRATION. FORTUNATELY, THERE'S A TOOL TO HELP OPTION TRADERS VISUALIZE DIFFERENT SCENARIOS.

WORDS BY
KEVIN LUND

PHOTOGRAPHS BY
DAN SAELINGER



Any camper knows you can't leave home without three tools: a map, a compass, and a Swiss Army knife. These tools help you get where you're going, give you directions if you get lost, and assist you with basic functions once you've made camp. Option traders also need to know where they are, where they want to go, and what could happen along the way when things don't go as planned.

When trading options, it's not just about the price of the underlying. Volatility (vol) and time also impact options prices—and therefore your profit and loss (P&L). What if the underlying moves up $10 but takes two weeks? Or what if the stock doesn't move but implied volatility (IV) increases 5%? What if IV spikes and the underlying moves? Or doesn't move? Having a "picture" of a potential trade can help remove some of the ambiguity from trading options.

PART 1

DEFINING THE HIGH LEVEL

In its simplest form, a risk curve shows how much an options trade can make or lose based on changes in the underlying.

A basic risk graph of a long call, like the one in Figure 1, displays hypothetical profits when the underlying price goes up and the losses when it drops.

By way of helpful tools, the **Risk Profile** tool on the thinkorswim® platform shows more than a simple risk graph. It helps you "see" elements that aren't necessarily apparent in the price of an option. The tool gives you a snapshot of a trade's risk/reward based on the underlying at the time you do your analysis, at expiration, and any point in between.

Just like a map shows you more than major roads, the **Risk Profile** tool lets you see plot lines that represent either multiple points in time (including the day of your analysis) or changes in the options IV and underlying. This data can help you get a better understanding of how your trade could perform.

TRADER GLOSSARY
TURN TO PAGE 33

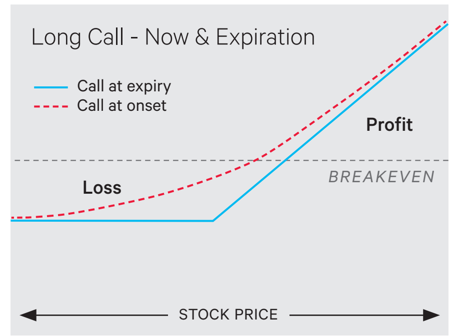


FIGURE 1: LONG CALL RISK CURVE.
For illustrative purposes only.

PART 2

PRICE, TIME, AND VOLATILITY

Things can change. What might happen to your trade if changes in time, vol, and underlying price happen simultaneously?

Fire up the thinkorswim platform and select the **Analyze** tab > **Add Simulated Trades** > a single option or spread. Then select **Risk Profile** (see Figure 2).

Figure 2 shows a long call with 37 days until expiration. The price of the underlying is displayed below the graph, while P&L is to the left. The graph defaults to displaying two lines:

- Today's P&L (curved purple line, labeled 1)
- P&L at expiration (blue line, labeled 2)

The short vertical red lines (labeled 3) are the break-even points for the trade for that time frame. Hover over the graph to see the projected P&L—it's based on theoretical options prices for one of the dates in the lower left corner of the graph (4).

The dashed orange vertical lines represent price slices. The middle slice (5) shows the current price of the underlying (in this case $313.20). Select the **Price Slices** panel to get more control over setting and locking price levels or to add or delete slices.

The shaded area shows the expected range of the underlying based on a one-standard-deviation move and the date in the upper right corner (6). More on this in a bit.

Below the graph are the simulated trades (7) you're analyzing. You can edit or delete the simulated trades or add others to preview adjustments. And if you want to exclude a trade, just uncheck it.

In Figure 2, if the underlying moves to $320.26 from $313.20, the trade could profit $404.19. But if it takes until expiration to get to $320.26, then the trade will have a loss of $448.97 (due to 50 days of time decay).

You may still want to close the trade with a loss even if the underlying goes up. When might that make sense? To better answer that question, you could add lines to the risk graph that represent the P&L at future dates. In addition to the line for the day of your analysis, add between one and four lines to the graph in any day interval you want.

For example, you could add three lines at 10-day intervals (see Figure 3). At the top of the graph, select **Lines:** > **Day Step** > **+3 @ Day Step** and change the interval to 10 using the +/- button. The lines represent the P&L for the day you're analyzing and 10, 20, and 30 days in the future. Hover over the graph to see the projected P&L for any

FIGURE 2: THE RISK PROFILE TOOL. From the **Analyze** tab on thinkorswim, add a simulated trade using either a single option or spread, then select the **Risk Profile** subtab. Here you see an analysis of a long call option for $9.75 with 50 days until expiration.
Source: thinkorswim. For illustrative purposes only.

time frame based on the price of the underlying. In this example, the trade breaks even at the 30-day time frame (white line) with the underlying at $319.39.

Remember the expected range in Figure 2? Change the date to one in the future you want to analyze. This is just a projection based on current IV, but it can help give you a better handle on how your trade might perform and when you might hit an exit in your trading plan.

To get back to a two-line risk graph like the one in Figure 2, **select Lines** > **Expiration** > **+1 @ Expiration.**

Similarly, you can preview how your trade might fare if IV changes. You can add up to four lines that show the effects of IV changes. Enter any interval or change the interval in 5% increments.

If the underlying drops, the long call will lose from delta. But what if the sell-off comes with an increase in vol? In Figure 4, the purple line shows the P&L based on the prevailing IV, but the other three lines show vol increasing in increments of 5%.

If the underlying sells off to $306.71 and vol remains the same, the trade loses $222.71. But if vol goes up by five points (from 27.89% to 32.89%), the trade breaks even because the vol spike offsets the loss to delta. With a 10-point jump in vol (orange line), the trade profits $224.98. Conversely, you could analyze what a drop in vol would do by entering a negative interval number.

If you want to take this one step further, add in the effects of time decay if there are changes to vol and the price of the underlying. Simply change the date in the **Positions and Simulated Trades** panel.

CHANGING THE LOOK AND FEEL

For more control over the look of your graph in the Risk Profile tool:

1 – Select the icon in the upper left next to **Drag chart to panDrag prices to change scale.**

2 – Select **Fixed Y Scale.**

3 – Select and drag on the Y scale (profit/loss) or the X scale (underlying price) to tweak the graph.

PART 3
STRATEGY PLANNING

Understanding how a tool works hypothetically is one thing; however, using it in the real world is another. The **Risk Profile** tool can potentially help make your trading decisions a little simpler when it comes to strike selection, position sizing, and entry/exit timing.

Let's start with options selection. Plug in your assumptions for the underlying price, time, and vol changes and see how your trade performs. Next, change the strike, expiration, or the entry/exit price. Different trades are going to provide different profit, loss, and break-even points. So, you can use the tool to home in on the trade that might work best for you.

Once you've found a trade that could work, you'll need to figure out how many contracts to trade. Position sizing is a personal choice, and the **Risk Profile** tool can help you better forecast when profit or loss exits might get hit.

If a projected loss is too big or comes too quickly, consider dialing back the position's size. If you expect the underlying to move, you may want to give it the time it needs. When you enter your assumptions into the tool, you could get an idea of whether you'll want to exit a trade based on a profit or loss or make an adjustment.

IF A PICTURE IS WORTH A THOUSAND words, the **Risk Profile** tool could be worth much more. It can potentially help reveal what you can't see in the numbers. Some traders can look at a list of numbers and visualize the big picture. Others like to have the big picture drawn for them. The Risk Profile isn't just for the "seeing is believing" crowd.

Kevin Lund is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

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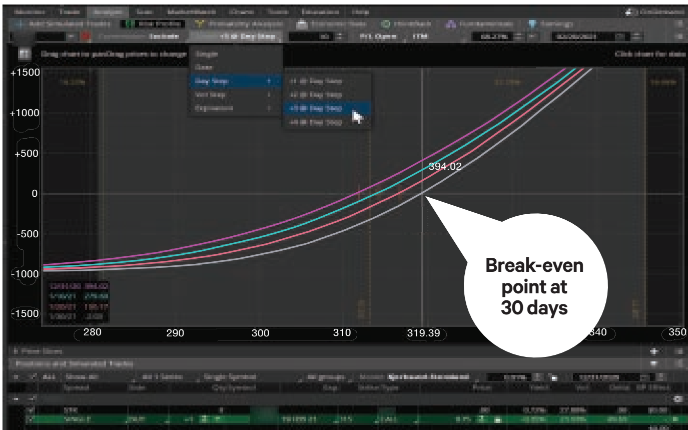


FIGURE 3: RISK PROFILE WITH DAY STEP. The Risk Profile tool on thinkorswim shows the plot line on the day of analysis, along with three additional plot lines at 10-day intervals. *Source: thinkorswim. For illustrative purposes only.*

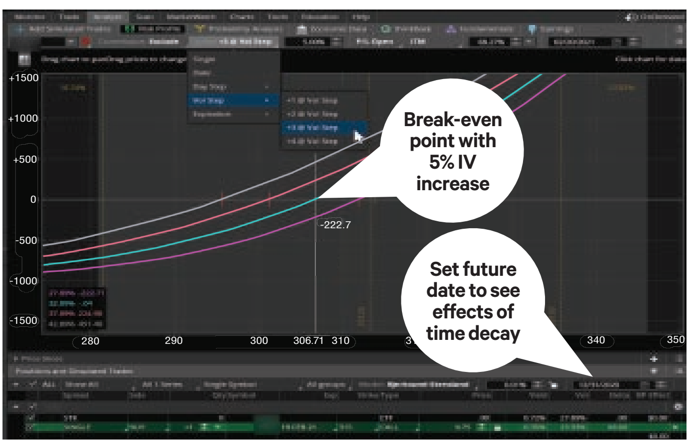


FIGURE 4: RISK PROFILE WITH INCREASING VOL. See how much you could potentially make or lose if vol increases or decreases. *Source: thinkorswim. For illustrative purposes only.*

SKILL LEVEL
PRO

TAKE AWAY:
Explore how to create synthetic positions.

PHOTOGRAPH: DOME STUDIO

YOUR OPTIONS KNOWLEDGE (TO SYNTHETICS AND BEYOND)

BIG IDEA:

SYNTHETICS ARE THE BUILDING BLOCKS OF THE OPTIONS WORLD. MARKET MAKERS OFTEN USE THEM TO HELP KEEP MARKETS ZIPPED UP TIGHT AND LIQUID. ONCE YOU UNDERSTAND THEM, YOU MIGHT FIND THEM USEFUL AS PART OF AN OVERALL OPTIONS TRADING STRATEGY.

WORDS BY **DOUG ASHBURN**

SYNTHETIC. PIECED TOGETHER.

Made by humans to imitate something else. In your closet, synthetics are clothes that can be mixed and matched to accessorize and slenderize. And in the options world, synthetics are what result from the mixing and matching of calls, puts, and stocks.

There's a tight relationship between the right to buy a stock (a call option), the right to sell it (a put option), and the stock itself. This relationship allows you to combine any two to mirror the risk profile of the third. Sound complicated? Maybe so, until you break it down.

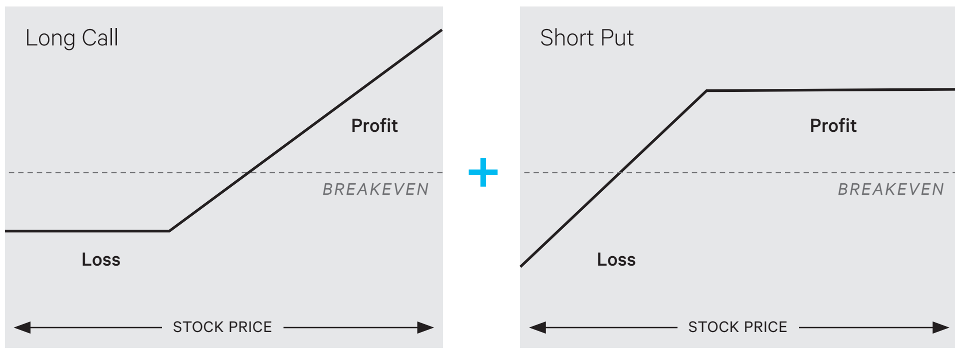


FIGURE 1: ANATOMY OF A SYNTHETIC STOCK POSITION. A long call plus a short put = a synthetic long stock.

SYNTHETICS: PIECE BY PIECE

Consider a long call position at any given strike. At expiration, if the underlying stock price is higher than the call's strike price, you could exercise the call and take a long position in the stock, if you wanted to own the stock. If it's below the strike at expiration, it expires worthless.

Now, look at a short put position at the same strike. If the stock price stays above the strike price through expiration, the option expires worthless. If it drops below the strike prior to or at expiration, the put would likely be assigned, and you'd be buying a long stock position.

Suppose you're long the call *and* short the put—same strike, same expiration date. At every point above and below the strike, one of the two options will be in the money (ITM) and could result in a long stock position if exercised or assigned. A long call paired with a short put mirrors the risk profile of a long stock position, so it's a "synthetic" long stock.

It's easier to see this visually (see Figure 1).

What about prior to expiration? Is the position fully synthetic then as well? For that, let's turn to delta.

If you're long the stock, it's 1.00 delta. If you hold 100 shares, for every dollar the stock rises, the value of the position increases $100. If it goes down $1, you're down $100. That's pretty simple. Likewise, if you're long a deep ITM call, it's essentially 1.00 delta and moves basically one-to-one with the stock. A put with that strike has a significantly lower chance of finishing ITM, so it likely has a near-zero delta.

Now suppose it's an at-the-money strike. It's 50/50 whether the call or put will be ITM at expiration. So, the call has a 0.50 delta, and the put delta is -0.50. Think of this as a 1.00 delta sandbox. At any point, the call delta minus the put delta (a double negative, so add them together) is always 1.00. If a call has a 0.30 delta, the corresponding put will be -0.70. If the call is 0.40, the corresponding put will be -0.60, and so on.

Again, if you're long the call and short the put at any strike, either you could exercise the call and become long the stock, or you could get assigned the put and be long the stock. Not both. But it's pretty much certain to be one of the two.

THE BIG SIX

Let's go a step further. If a long call paired with a short put is a synthetic long stock, then a short call with a long put is a synthetic short stock. Now move them around to and from different sides of the equation (like you did in algebra class) to get these six basic synthetics.

And remember: A standard U.S. equity options contract is deliverable into 100 shares of the underlying stock. So, for these six synthetic combos, it's one call, one put, and 100 shares of stock (see Figure 2).

Synthetic	=	Component 1	+	Component 2
Long underlying	=	Long call	+	Short put
Short underlying	=	Short call	+	Long put
Long put	=	Long call	+	Short underlying
Short put	=	Short call	+	Long underlying
Long call	=	Long put	+	Long underlying
Short call	=	Short put	+	Short underlying

FIGURE 2: THE SIX BASIC SYNTHETICS. These six building blocks create six basic synthetics. *For illustrative purposes only.*

Speaking of algebra, this relationship has a name and a formula. It's called the **put-call parity theorem**. Here's what it looks like:

S + P = C + K, where S = stock price, P = put premium, C = call premium, and K = strike price

The prevailing price of the underlying stock *plus* the put premium equals the strike price *plus* the call premium. Want to see it on the thinkorswim® platform? Take a look at Figure 3.

For the 51 strike:
$51.51[S] + $0.96[P] = 52.47
$1.47[C] + 51[K] = 52.47

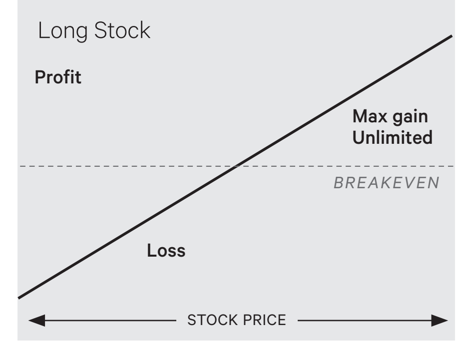
Rearrange the equation using basic algebra and you arrive at the other five equations. And using put-call parity, you could double-check if you're getting in at a fair price.

For example, suppose you want to synthetically get long by using the 51 strike. You'd buy the call and short the put. Using the mark prices in Figure 2, the call is $0.51 higher than the put price. And with the stock at $51.51, the 51-strike call is ITM by $0.51.

$$C - P = S - K.$$

Same formula—just rearranged algebraically.

And if you're looking at deltas, note that the absolute value of the call and put deltas add up to 100. At each of the strikes in Figure 3, buying a call and selling a put



For illustrative purposes only.

DON'T SNAG THAT SYNTHETIC

You know how that fab-looking polyester blend will occasionally get caught on a tree branch, and next thing you know, it's unraveling? Yup. The same can be said for options synthetics. Consider a few potential snags:

- **Early exercise.** Standard-listed options contracts are American style, which means they can be exercised at any time. So if you're short an ITM option as part of a synthetic, it's possible to get assigned ahead of expiration. That's not necessarily a bad thing. Just something to keep an eye on.

- **Dividends.** Dividends are paid to the owner of record as of the ex-dividend date. That's important for two reasons. First, a synthetic long stock position isn't actual ownership of the stock. Second, sometimes the owner of an ITM call will exercise early, giving up the remaining time value of the option in exchange for a claim on the dividend. If you're not comfortable with the ins and outs of dividend risk, it's best to steer clear of short ITM calls around dividend dates.

- **Pin risk.** ITM options—even if ITM by one penny—are automatically exercised at expiration. But the owner can override that if, for example, the stock moves after the close. And what if the stock settles right at the strike? It's not a common occurrence, but it happens more often than you might think. Just another way a synthetic is slightly different from the real thing.

TRADER GLOSSARY
TURN TO PAGE 33

will give you a delta of 1.00.

As a retail option trader—maybe one who sticks to basic strategies such as covered calls or vertical spreads—your entry and exit targets and overall strategy are working for you. And you might be thinking, "So what?"

Two answers.

First, if you trade options, you're already benefiting from synthetic relationships. Behind the scenes, market makers use them to keep bid/ask spreads as tight and liquid as possible. It keeps things from getting out of whack.

Second, once you're comfortable with synthetics, you might find—as many advanced traders do—you can potentially use them to more effectively and efficiently pursue your options trading objectives.

ACCESSORIZE WITH SYNTHETICS

Synthetic Stock Position

Say you've got a stock in your portfolio that you've owned for a long time. You think it could be headed for a pullback, but selling it might be a taxable event. You could shed some delta with a synthetic short stock position, and when your target's been met—for better or worse—you could undo the synthetic hedge, keeping the long position intact.

Alternatively, suppose you want to short a stock but can't (or don't want to) go through the borrowing process. A synthetic short stock position might be the answer. But keep in mind, like the short stock strategy, the short call component of this synthetic (if not covered by long stock in the account) is subject to unlimited risk of loss.

Covered Call Dressed Up

The synthetic short put combines a short call and a long underlying. And that's another name for a covered call—one of the more common strategy choices out there. Selling a cash-secured put at the same strike is a synthetic way to get the same risk/reward profile in one trade.

Convert It

Say you bought a put and it went your way—the stock dropped $5. You're sitting on a nice winner, but you're worried the stock might drift back higher. So, you buy the stock. You've now turned that position into a synthetic long call. Now, suppose the stock rallies. You could close out the stock and put *or* sell the corresponding call to lock in a synthetically flat position (long stock, long put, short call).

YOU GET THE IDEA. THERE'S A WHOLE wardrobe's worth of strategies that are only possible once you've opened yourself up to the world of synthetics. Consider trying one on in paperMoney®. You might find it fits your strategy objectives like a pair of spandex shorts.

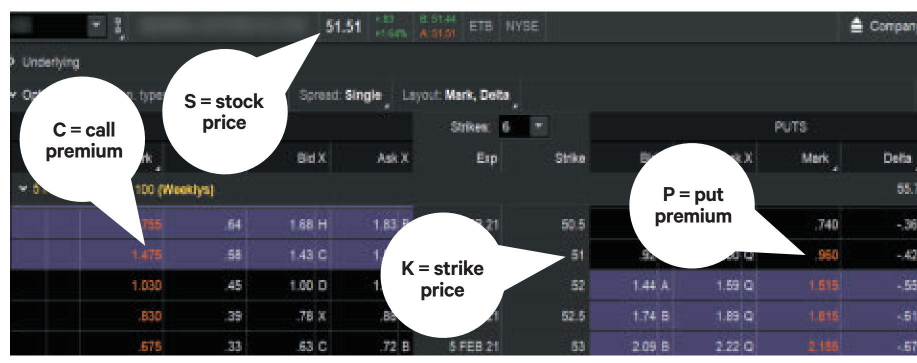


FIGURE 3: USING PUT-CALL PARITY. The four components—stock price, call premium, put premium, and strike price—can be put together algebraically to help with options pricing. *Source: thinkorswim. For illustrative purposes only.*

Doug Ashburn is not a representative of TD Ameritrade, Inc. The material, views, and opinions expressed in this article are solely those of the author and may not be reflective of those held by TD Ameritrade, Inc.

For more information on the risks of trading and trading options, see page 35, #1 & 2.

SKILL
LEVEL
SAVVY

TAKE AWAY:
Breaking down the main categories of ETFs.

BIG IDEA: THE ETF UNIVERSE IS BIG. VERY BIG. WITH SO MANY CHOICES OUT THERE, IT HELPS TO BREAK DOWN THE MOST POPULAR ETF CATEGORIES YOU'LL COME ACROSS BEFORE CHOOSING YOUR GO-TO.

HITCH A RIDE TO THE ETF GALAXY

WORDS BY **JAYANTHI GOPALAKRISHNAN**

PHOTOGRAPHS BY **DAN SAELINGER**

In one of the largest theme parks in the world, you can hop on and off a gondola and visit different resorts within the park. It's a great way to get a feel for each one and perhaps narrow your resort choices for your next vacation.

You can screen exchange-traded funds (ETFs) the same way. With a boatload of them—more than 1,800 ETFs in the market today, and many added each year—how do you get a lay of the land and decide which ones to trade?

First, think about why you might want to trade them. ETFs are like mutual funds in that they contain a basket of assets, but unlike mutual funds, they can be traded throughout the day just like stocks. Consider three main reasons many investors trade ETFs:

• **Diversification.** Instead of trading a single stock or commodity, you can spread out your risk by trading an ETF because they contain a group of assets.

• **Tapping alternatives.** Access markets you might not feel comfortable directly trading otherwise. You can trade ETFs that track bonds, commodities, or currencies.

• **Optionable.** With an appropriately approved account, you can trade options on more than 500 ETFs. They're American style, settle for the underlying shares, and expire on Fridays.

The downside? At times, the market value of an ETF will deviate from the value of the assets of the underlying index that it tracks. They also tend to have lower volatility compared to individual stocks, and some ETFs have very low liquidity.

Let's take a ride through the ETF galaxy and get familiar with some of the categories.

1 INDEX ETFs

- Underlying is based on an index.
- Tend to be more liquid.
- There are many to choose from.

GAME PLAN: Consider filtering for the most liquid index ETFs, check out their holdings, and then see how they're weighted. There are different types of indices tracked by ETFs such as S&P 500, Nasdaq, large cap, small cap, international, and so on. Options premiums on some index ETFs may be more capital intensive.

As an alternative, you could focus on specific sectors.

2 SECTOR ETFs

- The underlying is based on specific sectors.
- The S&P 500 has 11 broad sectors.
- To visualize sector performance:
  - Select the **MarketWatch** tab on the thinkorswim® platform.
  - Then, select **Visualize** > **Indices** > expand **S&P 500**.
  - All 11 sectors will be listed. Select one to get a glance via the **Heatmap**.

GAME PLAN: As you scroll down the sector list, perhaps you notice that Real Estate appears to be strong. To find ETFs that focus on Real Estate, log in to your tdameritrade.com account and check out the ETF Market Center. Look through the different sectors and find some that meet your trading criteria. Then add them to your watch list.

But what if you want to diversify your portfolio with assets uncorrelated to stocks?

3 BOND ETFs

- The underlying generally moves in line with its respective bond futures contracts.
- Economic data, such as changes in interest rates, can impact bond prices, especially those with the longest maturities.
- They give traders exposure to the bond market without trading futures.
- They're not as liquid as futures.
- Bonds and bond ETFs will typically decrease in value as interest rates rise.

GAME PLAN: Pull up a chart of the 30-Year Bond Futures (/ZB) on thinkorswim. Compare it with the chart of a 20- or 30-year Treasury-bond ETF. If both move in line, analyze price movement on the futures to help you make trading decisions. But only a couple of bond ETFs are liquid, so make sure the ETFs meet your minimum liquidity threshold. You could also try other ETFs that follow the futures market.

4 COMMODITY-BASED ETFs/ETNs

- Invest in physical commodities such as grains, livestock, energy, or precious metals.
- Can hold commodities in physical storage or invest in the physical commodity and use futures contracts.
- Some commodity exchange-traded products (ETPs) are technically exchange-traded notes (ETNs). See the sidebar, "What About ETNs?"
- Give you exposure to the commodity market without trading futures.
- Tend to be uncorrelated to stocks and bonds and can be used to provide a potential portfolio hedge.

GAME PLAN: Consider following a broad-based commodity index such as the Bloomberg Commodity Index ($BCOM). Then focus on charts of futures contracts such as crude oil (/CL) or gold (/GC). Say /CL is rallying. You could potentially trade a liquid ETF that holds a basket of crude oil futures.

Also, keep in mind that commodities can be volatile and are affected by world events, government regulations, and economic conditions.

Now that you've got a better lay of the land, you can conclude your journey. But if you want some turbulence, stick around.

What About ETNs?

ETNs are debt securities. Like ETFs, they track an underlying index. But because they're loans issued by financial companies, you're exposed to credit risk. ETNs also tend to be less liquid. But some ETNs give you exposure to products you typically may not have in the equity market, such as volatility or yield curves. So, they can be complex. And that means you really need to do your research before considering trading ETNs. To find out more, check out "Investing in Commodity ETFs: Agriculture, Oil, Gold ETFs, & More": **http://bit.ly/CommETF**

5 LEVERAGED/ INVERSE ETPs

- Leveraged ETPs (both ETFs and ETNs) seek to provide daily leveraged returns based on the performance of an underlying index they're tracking (e.g., 2x-3x). For example, a leveraged ETP may provide daily returns that are 3x the Russell 2000 Index.
- Inverse ETPs are designed to increase in value when the value of a particular underlying index declines. For example, a leveraged inverse ETP might move -2x the S&P 500 Index (SPX)—and when the index declines, the ETP will gain value.
- Typically riskier and more volatile and are not suitable for most investors.

These ETPs can be confusing and entail unique risks. So there's a lot to think about before trading them. They either win or lose more than the market, or they make money when doing the opposite of the markets they're tracking. Leveraged and inverse ETPs generate returns through the use of derivative positions. And because derivatives are taxed differently from equity or fixed-income securities, these ETPs may not have the same tax efficiencies that investors have come to expect from many ETPs. Most of these securities are designed for daily use only and not intended to be held overnight or long term, which means they have to be monitored and managed actively.

GAME PLAN: On thinkorswim, pull up a chart of a broad index, such as the SPX, select **Studies** > **Add study** > **Compare with** > **Custom symbol**… and enter a leveraged or inverse ETP symbol. It will overlay on the SPX chart. You can see when prices between the two were in line and when they diverged. Keep in mind that because leveraged/inverse ETPs are volatile, options premiums can be higher.

PAIRING UP

As you can imagine, there are many ways to trade ETF options: protective puts, covered calls, collars, and more. One strategy you may not have given much thought to is pairs trading. You can pair an underlying with an ETF (buy/sell ETF against a long/short stock position), pair two ETFs, pair two ETF options, and so on. Pairs trading can be applied when there's a divergence between a pair that typically correlates.

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Say the Technology sector has had a strong rally, but Utilities are weak. You think both sectors might revert to the mean. You could pair up a long Utility ETF with a short Technology ETF. It could be capital intensive, and if the pair moves against you, you might end up losing on both positions.

An alternative is to trade spreads using ETF options. For example, you could sell a put spread that's out of the money (OTM) on a Utility ETF and sell an OTM call spread on a Technology ETF. Because the risk is defined and you're putting up less capital, a loss may not be too catastrophic. But keep in mind that your max potential profit is limited and there could be a large capital requirement. And if Technology continues moving up and Utilities continue sliding, you could end up with losses on both sides of the trade.

You can figure out the correlation between two ETFs on thinkorswim (see Figure 1).

1. Select the **Charts** tab and enter the two symbols in this format: "ABCD–XYZ".
2. Select **Studies** > **Add study** > **All Studies** > **O-P** > **PairCorrelation**.

You'll see the **PairCorrelation** study displayed below the price chart. If the pair diverges, the indicator will drop. Even though it's not a guarantee, the indicator could help you decide whether to enter a pairs trade or not.

Although the ETF galaxy is made up of thousands of ETFs, adding just a handful to your watchlist of trading candidates can come in handy. Get to know what makes them unique and you could discover a whole new world of trading products.

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For more information on the risks of trading and trading options, see page 35, #1 & 2.

FIGURE 1: HOW WELL DOES THE PAIR CORRELATE? You can use a threshold such as 0.6 to make it simpler to visualize the correlation. Higher than 0.6 may be strong, and less than 0.6 may mean the pair isn't as correlated.
Source: thinkorswim. For illustrative purposes only.

CHECK IT OUT

DISCOVER:

ETF Market Center. Log in to tdameritrade.com. Select **Research & Ideas**, then **ETFs** > **Market Center**. Select **Sector Focused** and look at ETFs within each sector.

BONUS:

Volatility ETFs and ETNs. There's a class of volatility ETPs. Find out more by reading "Trading Volatility Products": **http://bit.ly/TT-VixProd**

Before investing in an ETF, be sure to carefully consider the fund's objectives, risks, charges, and expenses. For a prospectus containing this and other important information, contact us at 888-669-3900. Please read the prospectus carefully before investing.

ETNs are not funds and are not registered investment companies. ETNs are not secured debt and most do not provide principal protection. ETNs involve credit risk. The repayment of the principal, any interest, and the payment of any returns at maturity or upon redemption depend on the issuer's ability to pay. The market value of an ETN may be impacted if the issuer's credit rating is downgraded. ETNs may be subject to specific sector or industry risks. Leveraged and inverse ETNs are subject to substantial volatility risk and other unique risks that should be understood before investing. ETNs containing components traded in foreign currencies are subject to foreign exchange risk. ETNs may have call features that allow the issuer to call the ETN. A call right by an issuer may adversely affect the value of the notes.

Leveraged and inverse ETFs entail unique risks, including but not limited to use of leverage; aggressive and complex investment techniques; and use of derivatives. Leveraged ETFs seek to deliver multiples of the performance of a benchmark. Inverse ETFs seek to deliver the opposite of the performance of a benchmark. Both seek results over periods as short as a single day. Results of both strategies can be affected substantially by compounding. Returns over longer periods will likely differ in amount and even direction from the target return for the same period. These products require active monitoring and management, as frequently as daily. They are not suitable for all investors.

Equity pairs trading is not suitable for all investors and requires active monitoring and management as the special risks inherent may expose investors to potentially unlimited losses.

FIGURE 1: BEARISH PATTERNS AT RESISTANCE LEVELS. Reversal patterns at key resistance levels could be worth watching. But will there be a short-term correction, or will the trend direction completely reverse? You'll need to keep an eye on price action and short-term support levels. *Source: thinkorswim. For illustrative purposes only.*

Candlesticks and Options: Together at Last

A reversal pattern on a chart can help you form an opinion about price direction. Does that mean you jump in to the trade? Not necessarily.

• Ah, options. There are so many things you can do with them. But more choices can often lead to confusion. How do you decide which strategy to use, which strikes, which expirations? Consider these three ideas to help you in the decision-making process.

1. DETERMINE YOUR DIRECTIONAL BIAS

Fundamentals. Maybe there was some positive news that could help push prices higher in a sector or stock. Or perhaps the jobs numbers implied a particular sector might get hit hard. Maybe there's a stock in that sector on your watch list, one you've been itching to trade. You think the stock will move down, and you see a trading opportunity. Your directional bias seed has been planted.

Technicals. When should you place the trade? This is when looking at charts may help. Maybe you see a reversal candlestick pattern, such as a bullish engulfing or dark cloud cover, at a key support or resistance level. It's tempting to make a trade, but you'll have to decide which strategy to use and how long you want to stay in the position. A bit more analysis may bring you closer to a thoughtful decision.

2. TAKE A HISTORICAL LOOK

It can be helpful to go back in time to see if similar patterns have occurred. If so, did price move as expected? How long did it take for the price movement to reverse? Analyzing chart patterns from this perspective gives you an idea of how long you could anticipate staying in a trade. But anything can happen after you place the trade, so be prepared with exit conditions.

In Figure 1, a dark cloud cover formed at a key resistance level (previous high) in late December (purple line). Soon afterward, price retraced to a support level (blue line), and looked like it might reverse to the upside. Would this be a good time to put in a trade?

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A few observations:

• Go back a few months. In September, price reached a high at the same level (bearish engulfing pattern) and reversed. It took about 12 days from that high to the low.

• Price started trending higher and reached a short-term high in mid-October (dark cloud cover). That took 15 days.

• Price reversed direction and reached a short-term low after 14 days. After that, price trended higher until the December high.

• Since the December high, price retraced and looks to be bouncing off a support level around $126. It's been 13 days since that high and, based on previous price action, price could reverse. Yet, any negative news could send prices lower.

3. SELECT YOUR STRATEGY

You've formed a bullish directional bias, so you could consider buying calls or selling puts. But which strike and expiration should you choose? And how do you hedge your position against a downside move?

Looking at Figure 1, if you think price will reverse and move higher, one alternative would be to sell the 122/127 put spread. You'd make some money if the stock moves up, but limit your risk if price moves lower. If you think price will remain in a trading range between the 126 and 138 levels, you could put on an iron condor with strikes around those two levels. Since it takes about 14 days on average from high to low, you could choose expirations at least 30 to 45 days out to potentially capture the move.

There are many ways to approach thoughtful trading. And applying a methodical process can help you find potential opportunities to capture a market's expected moves. Mapping and planning also reduce the likelihood of staying in a trade that isn't performing to expectations.

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At the money (ATM)—An option whose strike is "at" the price of the underlying equity. Like out-of-the-money options, the premium of an at-the-money option is all "time" value.

Butterfly spread—Typically a market-neutral, defined-risk strategy composed of selling two options at one strike and buying one each of both higher- and lower-strike options of the same type (either all calls or puts). The strategy assumes the underlying will remain relatively unchanged during the life of the trade, in which case, as time passes and/or volatility drops, the combined short options premiums exhibit more decay than the combined long options premium, resulting in a profit when the spread can be sold for more than its original debit (which is its maximum loss).

Collar—A collar combines a long stock position and the writing, or selling, of a call option with the purchase of a put at the same expiration. Typically, this involves a call and a strike price above that of the underlying stock and a put with a strike below the stock. The strikes create "floor" and "ceiling" prices, "collaring" the underlying stock in between. In return for accepting a cap on the stock's upside potential, the investor receives a minimum price at which the stock can be sold during the life of the collar.

Delta—A measure of the sensitivity of an option to a $1 change in the underlying asset. All else being equal, an option with a 0.50 delta (for example) would gain $0.50 per $1 move up in the underlying. Long calls and short puts have positive (+) deltas, meaning they gain as the underlying gains in value. Long puts and short calls have negative (–) deltas, meaning they gain as the underlying drops in value.

Implied volatility—The market's perception of the future volatility of the underlying security, directly reflected in the premium of an option. Implied volatility is an annualized number expressed as a percentage (such as 25%), is forward-looking, and can change.

In the money (ITM)—An option whose premium contains "real" value, i.e., not just time value. For calls, it's any strike lower than the price of the underlying equity. For puts, it's any strike that's higher.

Iron condor—A defined-risk, short spread strategy constructed of a short put vertical and a short call vertical. The trader assumes the underlying will stay within a certain range (between the strikes of the short options). The goal: as time passes and/or volatility drops, the spreads can be bought back for less than the credit taken in or expire worthless, resulting in a profit. The risk is typically limited to the largest difference between the adjacent and long strikes minus the total credit received.

Long vertical—A defined-risk, directional spread strategy composed of long and short options of the same type (i.e., calls or puts). Long call verticals are bullish, whereas long put verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade.

Put spread—A put spread options strategy involves buying and selling equal numbers of put contracts simultaneously. Spread strategies can also entail substantial transaction costs, including multiple commissions, which may impact any potential return.

Short vertical spread—A defined-risk, directional spread strategy composed of an equal number of short (sold) and long (bought) puts with the same expiration. The credit from the short strike is greater than the debit of the long strike, resulting in a net credit taken into the trader's account at the onset. Short put verticals are bullish. The risk in this strategy is typically limited to the difference between the strikes minus the received credit. The trade is profitable when it can be closed at a debit for less than the credit received. Break-even is calculated by subtracting the credit received from the higher (short) put strike.

Vega—A measure of the sensitivity of options to a one-percentage-point change in implied volatility. For example, if a long option has a vega of 0.04, a one-percentage-point increase in implied volatility will increase the options premium by $4 per contract.

Vertical spread—A defined-risk, directional spread strategy composed of a long and a short option of the same type (that is, calls or puts). Long verticals are purchased for a debit, while short verticals are sold for a credit at the onset of the trade. Long call and short put verticals are bullish, whereas long put and short call verticals are bearish. The risk of a long vertical is typically limited to the debit of the trade, while the risk in the short vertical is typically limited to the difference between the short and long strikes minus the credit.

Accumulate, Liquidate, Procrastinate? Put Sellers and the Roll Decision

At some point, a cash-secured put may go in the money. How should you play it?

• Selling a cash-secured put starts with the idea that you'd be prepared to own a stock if it fell to a certain price. Suppose FAHN is trading at $100, and you'd love to own it at $94. So you sell the 95 put for $1, making your effective entry price $94 (not including transaction costs). If FAHN stays above the strike through expiration, you keep the premium and could repeat the process.

But what about when FAHN approaches—or goes through—the strike before expiration? What do you do? Consider your choices:

1 – Accept the assignment. Cash-secured put sellers often refer to this as a stock accumulation strategy. You sold that 95 put because you'd like to own FAHN at an effective price of $94. You get assigned and buy the stock.

2 – Buy back the short put. You liquidate the position, take your losses, and move on.

3 – Roll it down and out. It's a diagonal spread. Buy in your short option and sell a lower strike in a deferred expiration date. Depending on the net premium, you can lower your effective entry point.

Which strategy do you choose? It all comes down to your objectives. Did they change? Remember, you started with the premise of "I'd love to own FAHN at $94." Still in love? Are the fundamentals (earnings growth, competitive dynamics) and/or technicals (support level, trend) still intact? If so, maybe this is a good entry point.

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If you still like FAHN, but you've lowered your entry target, the down-and-out roll might be just the thing. But now it's a matter of choosing the right option. What's your target and time frame? Is it $92 and two weeks? Or $85 and two months? Weekly options and tight strike prices give you plenty of flexibility.

Always be sure to follow your objectives. Don't roll just because you don't want to book a loss. That's one of those cognitive boo-boos that can be mentally and financially draining.

And if you decide to liquidate and move on, let it be a learning experience. Was your underlying premise wrong from the get-go? If so, the accumulation strategy may not have been the right one for you. Perhaps consider a vertical put spread instead—you'll take in less premium, but you'll have defined risk. Your loss will be limited to the difference between your strikes, minus the premium, plus transaction costs.

A put rolling strategy works the other way too. If FAHN has been rallying—and you've been periodically selling FAHN puts—you might raise your target accumulation point along with it. Some traders track all the premiums they've collected to raise their target. It's a way to participate in the upside exposure without owning the stock outright. But if and when it returns to your target, remember to check your objectives before deciding whether to accumulate, liquidate, or roll. —Words by DOUG ASHBURN

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For more information on the risks of trading and trading options, see page 35, #1 & 2.

PHOTOGRAPH: DAN SAELINGER

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The information contained in this article is not intended to be investment advice and is for illustrative purposes only. Be sure to understand all risks involved with each strategy, including commission costs, before attempting to place any trade. Clients must consider all relevant risk factors, including their own personal financial situations, before trading. Past performance of a security or strategy does not guarantee future results or success.

Transaction costs (commissions and other fees) are important factors and should be considered when evaluating any options trade. Options are not suitable for all investors, as the special risks inherent to options trading may expose investors to potentially rapid and substantial losses. Options trading is subject to TD Ameritrade review and approval. Please read Characteristics and Risks of Standardized Options *(http://www.optionsclearing.com/about/publications/character-risks.jsp) before investing in options.*

It is not possible to invest directly in an index.

2

OPTIONS STRATEGIES

Trading options involves unique risks and is not suitable for all investors.

Spreads, condors, butterflies, straddles, and other complex, multiple-leg options strategies can entail substantial transaction costs, including multiple commissions, which may impact any potential return. These are advanced options strategies and often involve greater risk, and more complex risk, than basic options trades. Be aware that assignment on short options strategies discussed in this article could lead to unwanted long or short positions on the underlying security.

The maximum potential reward for a long put is limited by the amount that the underlying stock can fall. Should the long put position expire worthless, the entire cost of the put position would be lost.

When trading short options strategies, there is a risk of getting assigned early on the options sold, even if they go in the money by $0.01, obligating you to deliver shares you don't own (in the case of a short call) or purchase shares (in the case of a short put).

The risk of loss on an uncovered short call options position is potentially unlimited because there is no limit to the price increase of the underlying security. Option writing as an investment strategy is absolutely inappropriate for anyone who does not fully understand the nature and extent of the risks involved.

Short naked put and cash-secured put strategies include a high risk of purchasing the corresponding stock at the strike price when the market price of the stock will likely be lower.

Short naked options strategies involve the highest amount of risk and are only appropriate for traders with the highest risk tolerance.

A covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)

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SPREAD DISCLOSURES

Options collar: *The collar position involves the risks of both covered calls and protective puts.*

Options covered call: *The covered call strategy can limit the upside potential of the underlying stock position, as the stock would likely be called away in the event of a substantial stock price increase. Additionally, any downside protection provided to the related stock position is limited to the premium received. (Short options can be assigned at any time up to expiration regardless of the in-the-money amount.)*

Options long put: *The maximum potential reward for a long put is limited by the amount that the underlying stock can fall. This strategy provides only temporary protection from a decline in the price of the corresponding stock. Should the long put position expire worthless, the entire cost of the put position would be lost.*

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TDA 2012 07/21